DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0460
Sales and Use Tax
For Tax Years 2003-05

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ISSUE

I. Sales Tax—Imposition

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-1; 45 IAC 2.2-4-2

Taxpayer protests the assessment of sales tax.

II. Tax Administration—Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a graphic design business in Indiana. Taxpayer designs brochures, letterheads, business cards, logos, and banners using a computer. Taxpayer also takes digital photographs and creates digital photo files for businesses to use in brochures and on websites. Both parties agree that Taxpayer does not perform printing for customers. All designs are provided to customers on compact discs ("CDs") or through electronic media, which are then taken to commercial printers. If a CD is used to transfer the design to the customer, then once the customer receives the design it extracts the electronic data and returns the CD to Taxpayer.

After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed sales tax and assessed negligence penalties for the tax years 2003, 2004, and 2005. Taxpayer protested this imposition of the tax and penalties. An administrative hearing was held, and this Letter of Finding results.

I. Sales Tax—Imposition

DISCUSSION

On initial assessment, the Department found that Taxpayer was a "retail merchant" providing pre-press activity for commercial printing, which is not exempt from sales tax. The Department also analogized the Taxpayer selling the design CDs to the retail transaction of selling a software program CD, music CD, or other digital information encoded on a CD. "Retail transactions" are subject to gross retail (sales) tax as imposed under IC § 6-2.5-2-1(a). As a result, a sales tax withholding account was opened for Taxpayer.

IC § 6-2.5-4-1(a)-(c) defines a "retail merchant" involved in "retail transactions," as follows:

> (a) A person is a retail merchant making a retail transaction when he engages in selling at retail.
> (b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
> (1) acquires tangible personal property for the purpose of resale; and
> (2) transfers that property to another person for consideration.
> (c) For purposes of determining what constitutes selling at retail, it does not matter whether:
> (1) the property is transferred in the same form as when it was acquired;
> (2) the property is transferred alone or in conjunction with other property or services; or
> (3) the property is transferred conditionally or otherwise.

In summary, a retail merchant performing retail transactions is a person who obtains and sells tangible personal property, regardless of the fact that the person has changed or combined the acquired property with other property or services prior to the sale.

Taxpayer disagrees with the Department's analysis and asserts that sales tax has been assessed on payments for services. Taxpayer maintains that Taxpayer is not a "retail merchant," but is a "service provider" entitled to an exemption from sales tax under 45 IAC 2.2-4-2.

"Service providers" are given an exemption to the gross retail tax as provided in 45 IAC 2.2-4-2(a), as follows:

> (a) Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant unless:
> (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
> (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
> (3) The price charged for tangible personal property is inconsequential (not to exceed 10[percent]) compared with the service charge; and

> (4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.

Accordingly, a person who obtains and sells tangible personal property that has been combined or altered with services is a "retail merchant" unless the person is a "service provider" as defined under 45 IAC 2.2-4-2(a)(1)-(4).

Taxpayer has provided sufficient documentation to establish that Taxpayer is not a retail merchant, but is a service provider. Taxpayer is a "serviceman" in "an occupation which primarily furnishes and sells services," uses "the tangible personal property . . . as a necessary incident to the service," charges a price for the "tangible personal property" that is "inconsequential compared with the service charge," and "pays gross retail tax or use tax upon the tangible personal property at the time of acquisition."

Taxpayer's customers purchase the Taxpayer's ability to design brochures, logos, and business cards. Taxpayer used the CDs and electronic media only as a means to transfer the original copy of the designs to the customers. Taxpayer provided designs, but no finished products on which those designs were used. Other businesses, such as commercial printers, provided the tangible personal property with the designs on them to the customers, and those purchases were subject to sales tax. Therefore, if Taxpayer were producing additional copies of the designs for general sale, at that point Taxpayer would no longer be functioning as a service provider but would be a "retail merchant" transferring tangible personal property subject to tax. However, since Taxpayer provides only the original copy of the design to the customer by CD or email, Taxpayer qualifies as a service provider whose receipts were not subject to sales tax. Therefore, the sales tax account should not have been opened for taxpayer and will be closed effective January 1, 2003.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration—Negligence Penalty

DISCUSSION

The Department issued proposed assessments and ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides, "if a person . . . incurs, upon examination by the department, a deficiency that is due to negligence . . . the person is subject to a penalty. The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and

> prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, since Taxpayer has established that it does not owe the proposed assessments as discussed in Issue I, Taxpayer has affirmatively established that there was not a failure to pay deficiencies and accordingly that it exercised ordinary business care, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest to the imposition of the penalty is sustained.

AB/WL/DK – June 4, 2007